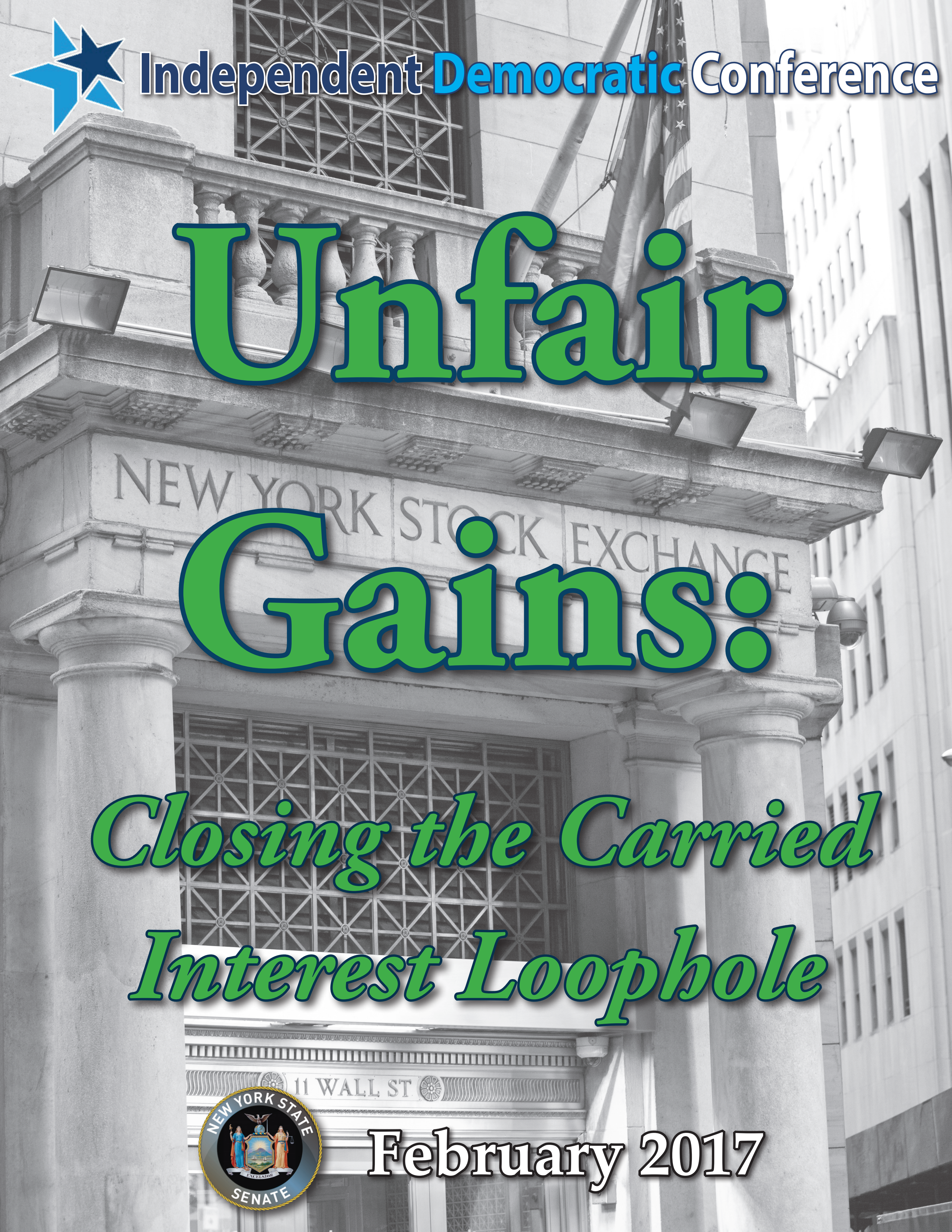
Independent Democratic Conference

Unfair Gains:

Closing the Carried Interest Loophole



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Introduction:

In March of last year, New York State Senator Jeffrey D. Klein, leader of the Independent Democratic Conference (IDC) announced the introduction of Senate Bill 7091 with the Strong Economy for All Coalition and the Patriotic Millionaires. This legislation is a response to the failure of the federal government to close the carried interest tax loophole, which gives fund managers preferential treatment for their income that we don't extend to everyday, equally hardworking people. The measure would create a 19.6% "carried interest fairness fee" on income earned by fund managers for investment management services that are currently incorrectly taxed as capital gains as opposed to regular labor income. This January the legislation was reintroduced in the Senate and is now Senate bill 1991. Based on newly received data from the Securities and Exchange Commission (SEC), the IDC, the Strong Economy for All Coalition and the Patriotic Millionaires estimate that New York State stands to gain **$3.5 billion** in new revenues if this fee went into effect. This revenue can then be invested back into building a stronger economy for all by helping to better finance our schools, our healthcare system, and to provide basic social services that help give every day New Yorkers a chance to thrive.

What is Carried Interest?

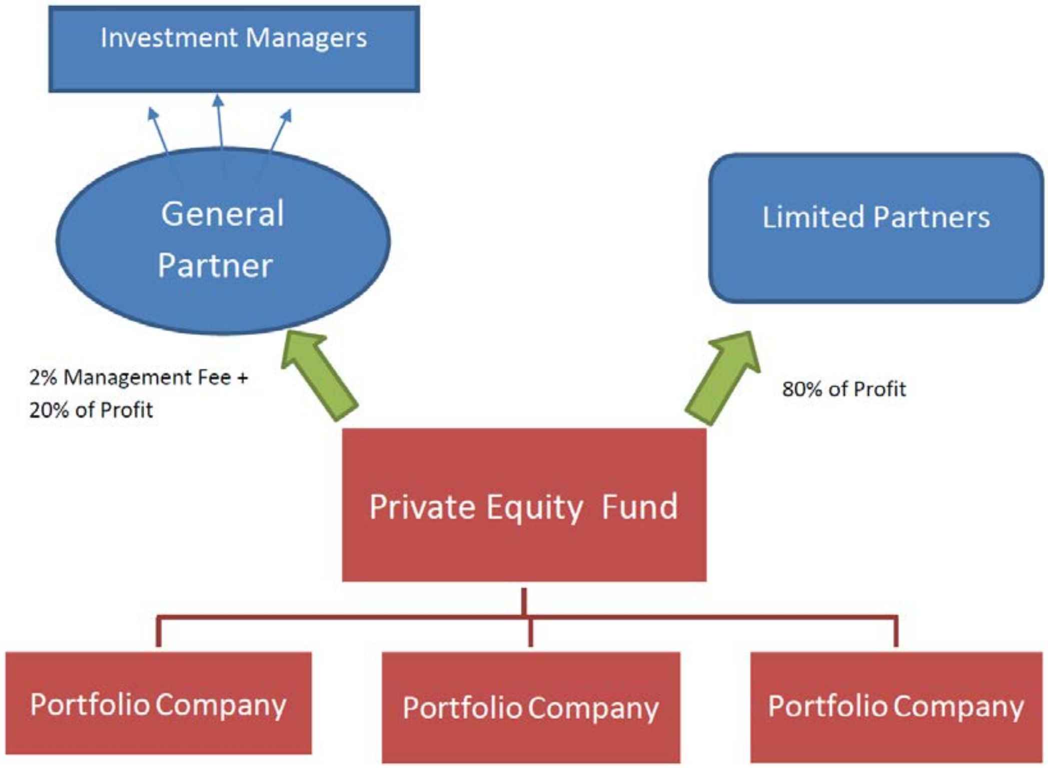
The term "carried interest" goes back to pre-modern times, originating with Italian merchants who would earn a cut of the profits (usually a fifth of the profit) from the sale of cargo in return for successfully shipping that cargo to market[1]- it was the interest they earned carrying the goods. With time, and with the growth of modern finance, the use of the term has changed significantly. Today it refers primarily to the gains that the manager of a fund will receive for profits realized under their management, whether that manager had any of their own capital invested in the fund or not.

When we say fund, we mean private equity and hedge funds. Private Equity funds exist to buy and sell other businesses. They stand to profit if they are able to sell the business they acquired for more money than they spent to purchase it. Hedge funds invest generally in financial instruments such as stocks and bonds (as opposed to more fixed assets like actual businesses) and profit if they are able to sell them off at a higher price. Hedge fund managers often devise complex investment strategies to try to 'beat' the market and realize higher than average returns.

These types of funds are structured as partnerships with two levels of partners, the general partners and the limited partners. Limited partners are the main providers of funding – they put forward the bulk of the capital that the fund uses to either acquire companies or more liquid assets. Big institutional investors such as pension funds and wealthy individuals are commonly the limited partners. General partners are responsible for the everyday running of the fund and for the investment decisions. These partners may also put in some of their own capital into the fund, if they had sufficient capital to begin with.

[1] http://rubicon.vc/the-term-carried-interest-goes-back-to-the-medieval-merchants-in-genoa-pisa-florence-and-venice/

Typical Structure of a Private Equity Fund



Profits from a partnership are not taxed at the firm level, but instead each partner's share is taxed individually. This means that the way in which a partner's profits are structured and classified has significant tax implications[2].

General partners convince institutional investors and wealthy individuals to become limited partners by promising a certain rate of return on their investment. Any profits realized by the fund up to this promised rate of return go to the limited partners. The general partners are motivated to produce profits that beat this benchmark rate by the promise that profits beyond this benchmark are split between the limited partners, who get 80% of these profits, and the themselves, who receive the remaining 20%. This 20% of the profits beyond the promised benchmark is the carried interest. General partners are also compensated with a management fee, on average 2% of the total assets under management, which is supposed to cover the expense of the fund, such as paying salaries for investment managers, other staff, and rent as well as providing a basic salary for the general partners[3]. This compensation structure for general partners is usually referred as the "2 and 20" pay formula[4].

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[2] http://www.fas.org/sgp/crs/misc/RS22689.pdf
[3] https://www.icaew.com/-/media/corporate/files/technical/corporate-finance/financing-change/tecplm12976_privateequityiii_main-section-2.ashx?la=en
[4] http://www.fas.org/sgp/crs/misc/RS22689.pdf

What is the Carried Interest Loophole?

The "2 and 20" payment formula forms the most common basis for compensating fund managers in the private equity and hedge fund world. The amount of funds invested in these partnerships is vast, meaning that any change in the rate at which income is taxed can have very significant revenue implications. According to Forbes Magazine[5] for example, the top 25 most highly compensated hedge fund managers in the US earned a combined $10.745 billion just in 2015.

The tax code does not treat all forms of income equally. Currently, the top marginal rate for income earned from regular labor is 39.6% for any income above $415,000 for single filers or $467,000 for married joint filers[6]. Income that is in theory earned from gains on an investment that is held for more than a year is classified as capital gains income, which is taxed at 15% as long as that amount does not push the total income of the filer above the $415,000 for single filers or $467,000 for married joint filers[7]. Any capital gains that push total income above these thresholds or are earned by someone who has to file under the highest income tax bracket are taxed at a 20% rate. Given the incomes derived from vast sums of money, fund managers would rarely have incomes that are not being taxed at the highest marginal rate, so for the purposes of this discussion, it is safe to assume that anything classified as regular income would be taxed at the 39.6% rate and any income classified as capital gains would be taxed at the 20% rate.

The 2% management fee portion of the "2 and 20" formula is treated as regular labor income, taxed at the 39.6% rate. The carried interest portion of the manager's compensation package is treated differently – it is taxed as capital gains. This discrepancy in the tax treatment between these two parts of the compensation structure is the carried interest loop hole.

The majority of tax professionals criticize how this income is categorized[8]. These professional view this carried interest as a form of a performance fee, an inducement to maximize the profits for the limited partners, who are the principle or sole sources of the money in the fund. Performance fees are a form of regular income. Managers of private equity and hedge funds are paying a much lower fee for this income than any other worker would pay for their labors. The difference between the two top rates is 19.6%. These high income earners are seeing their tax bill cut almost in half.

How can we Close this Loophole?

During the Presidential election of 2016, both major presidential candidates, Hillary Clinton and now President-elect Donald Trump[9] called for the closing of the carried interest loop hole. Unfortunately, the financial industry is working overtime to stop any change at the federal level. Data from the Center for Responsible Politics shows that the hedge fund and private equity industries spent a total

[5] http://www.forbes.com/hedge-fund-managers/list/#tab:overall
[6] https://www.irs.com/articles/2016-federal-tax-rates-personal-exemptions-and-standard-deductions
[7] http://www.schwab.com/public/schwab/nn/articles/Taxes-Whats-New
[8] http://www.taxpolicycenter.org/briefing-book/key-elements/business/carried-interest.cfm
[9] http://www.usatoday.com/story/opinion/2015/09/15/hedge-fund-carried-interest-donald-trump-jeb-bush-editorials-debates/72268922/

of $15.8 million in lobbying in 2015[10], up from a mere $4.1 million in 2006. The current vast lobbying spending spree began in 2007, the first year in which Congress took an interest in closing the carried interest loop hole.

Instead of waiting for the federal government to act, States can be proactive in remedying the negative consequences of the carried interest loop hole. States can capture the revenue that is being lost because of this loophole through their own taxing powers. Senate bill 1991, introduced by Senator Klein and supported by the Strong Economy for All Coalition and the Patriotic Millionaires, and its companion bill, Assembly bill 3554 which is sponsored by Assemblyman Jeffrion Aubry, would amend New York's corporate franchise and personal income tax laws to impose a 19.6% "carried interest fairness fee" on carried interest income that is currently being taxed as long-term capital gains as opposed to regular income.

One of the common arguments used to argue against tax increases on high income individuals is that high income individuals are highly mobile, and that any tax increases in one jurisdiction will simply lead them to move their residence for tax purposes to a location with a lower tax rate. There is very little evidence that this is ever the case[11], but in order to assuage concerns that this specific fee would lead to such movement, this legislation is designed to only go into effect when legislation with the same tax implications is passed in the four Middle Atlantic and New England states where fund managers are most likely to live, New York, Connecticut, New Jersey, and Massachusetts. Assemblyman Troy Singleton has introduced this proposal in the New Jersey General Assembly as Assembly bill 3868. In Massachusetts, State Senator Patricia Jehlen introduced Senate bill 2050. In Connecticut, 30 Representatives and four State Senators introduced House bill 6554.

How Much Revenue Would Closing the Loophole Raise?

In order to figure out how much money New York State could raise by moving to close the carried interest loop hole, the Strong Economy for All Coalition first submitted a Freedom of Information Law (FOIL) to the SEC to get data on the number of fund managers registered in New York State.

A "master list" of all fund registered investment advisors was obtained from the SEC. Data for Schedule D of Question 7(b)(1) of the investment advisor public disclosure for the previous five filing quarters was matched, using the reference ID field, with firm data provided in Question 1. Matched data was then de-duplicated by file date and reference ID, yielding 37,602 unique funds. Of these, 14,060 were managed by registrants who listed their principle office within New York State. Exempt reporting advisors were totaled similarly, and comprised 504 hedge funds and 430 private equity funds. Combined, these New York hedge funds reported gross assets under management of $3.08 trillion, while New York private equity funds had $1.15 trillion.

To estimate total earnings, Coalition analysts used private equity and hedge fund return benchmarks for a five-year period. For hedge funds, analysts used the Hedge Fund Research Inc. (HFRI) Fund

[10] http://www.opensecrets.org/industries/lobbying.php?cycle=2016&ind=f2700 and http://www.opensecrets.org/industries/lobbying.php?ind=F2600

[11] http://www.citylab.com/politics/2016/06/do-taxes-really-cause-the-rich-to-move/487835/

Weighted Composite's 36-month average.[12] For private equity, analysts used the Cambridge Associates U.S. Private Equity Index 5 year end-to-end pooled return published for the fourth quarter (Q4) of 2015.[13] By multiplying the return benchmarks by the assets under management (AUM), analysts came up with a rough estimation of expected annual earnings. This amounted to approximately $90.5 billion in annual returns for hedge funds and $148 billion in returns for private equity funds.

Next, analysts estimated the carried interest apportioned to hedge fund and private equity managers. Carried interest applies only to the incentive fee earned by hedge fund and private equity managers. Analysts used 15% of the total of hedge fund and private equity expected annual earnings to arrive at the expected aggregated fund manager annual earnings. A 15% rate was used because this is considered an extremely conservative rate. With hedge funds, 20% is the industry standard and 17.14% was the industry average for new funds launched in 2013, as tracked by the company Preqin, the leading private aggregator of data for hedge funds and private equity funds.[14] In private equity, the 20% standard is prevalent in 85% of co-mingled funds, according to a 2015 report by Preqin.[15] Separate accounts, where approximately one-third of investor capital was committed in late 2014,[16] are less likely to charge a 20% carry, although 90% charge 10% or more.[17] Based on these calculations, New York based hedge fund managers would receive aggregate annual earnings of $13.6 billion and private equity managers would see $22.2 billion in aggregate annual earnings.

To calculate the amount lost to carried interest exemptions, analysts halved the expected aggregate fund manager annual earnings. This was done to reflect the individual reporting of taxes paid on partnerships interest in financial service partnerships. Professor Victor Fleisher, a tax professional whose work was influential in beginning the current debate on the carried interest loop hole, discovered in his work on the subject that the IRS Statistics of Income shows that roughly half of financial industry partnership income is paid at the favorable carried interest rate.[18] [19] Halving the expected aggregate fund manager annual earnings gives us an estimate of approximately $6.8 billion in earnings for hedge fund managers and $11.1 billion in earnings for private equity managers that is being taxed under the long-term capital gains rate (20%) as opposed to the 39.6% top marginal income rate. These are the amounts that would be eligible for the 19.6% fairness fee. If one applies the fairness rate to these estimated earnings, then $1.33 billion would be raised by applying the fairness rate to hedge fund managers doing business in New York, and $2.17 billion would be

[12] https://www.hedgefundresearch.com/family-indices/hfrx#
[13] http://40926u2govf9kuqen1ndit018su.wpengine.netdna-cdn.com/wp-content/uploads/2016/05/Public-2015-Q4-US-Private-Equity.pdf
[14] https://www.preqin.com/blog/0/8340/hedge-funds-fees
[15] https://www.preqin.com/docs/press/Fund-Terms-Sep-15.pdf
[16] http://www.pionline.com/article/20141222/PRINT/312229973/assets-invested-in-separate-accounts-starting-to-add-up
[17] http://www.valuewalk.com/2015/09/48-of-private-equity-separate-accounts-charge-a-20-performance-fee/
[18] 56% of the income generated by finance and insurance partnerships in 2012 was taxed at this rate.
[19] www.nytimes.com/2015/06/06/business/dealbook/how-a-carried-interest-tax-could-raise-180-billion.html

raised by applying the fairness rate to private equity managers. This leads us to a total new revenue estimate of $3.5 billion for New York State[20].

	Assets Under Management by funds in New York	Expected Returns	Carried Interest income subject to loophole	Fairness Fee	Revenue Raised
Hedge funds	$3.088 trillion	$90.5 billion	$6.79 billion	19.60%	$1.330 billion
Private equity funds	$1.115 trillion	$147.9 billion	$11.1 billion	19.60%	$2.174 billion
				TOTAL:	**$3.504 billion**

Why Closing the Carried Interest Loophole Matters:

Earlier this year the Pew Research center released a poll that showed that almost two thirds of all Americans agree with the statement that our economic system unfairly favors powerful interests, with high income conservatives being the only section of the population that disagreed with that statement. Gallup[21] also released a poll that showed that a similar portion of Americans – over 60%, agree that the wealthiest in this country pay too little when it comes to federal taxes. The polling shows that Americans are not blind to the growing inequality of incomes in this country. This feeling that working class Americans are being left behind and that the rich and powerful are ignoring them has led to growing discontent and is believed to have had an important role in the outcome of the recent Presidential election.

A report from the Economic Policy Institute[22] from earlier this year highlights the growing income inequality in this country, and unfortunately, New York State and Connecticut lead the country in income inequality, with New Jersey and Massachusetts also falling into the top ten. As President Obama stated,[23] we live in a country where the 25 best compensated hedge fund managers earn more than all of the nation's kindergarten teachers.

Policies like the carried interest loop hole have helped widen this inequality, particularly in a state like New York where high earning fund managers can end up paying lower tax rates than middle class professionals like nurses or teachers. Closing the carried interest loop hole not only helps to make the tax code fairer, but it also provides revenue that can then be used to better serve our

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[20] Table with specific steps outline in Appendix
[21] http://www.gallup.com/poll/190775/americans-say-upper-income-pay-little-taxes.aspx
[22] http://www.epi.org/files/pdf/107100.pdf
[23] https://www.washingtonpost.com/news/the-fix/wp/2015/05/12/the-top-25-hedge-fund-managers-earn-more-than-all-kindergarten-teachers-combined/?utm_term=.a76a1e64783d

communities. The additional $3.5 billion that analysts have estimated closing the carried interest loop hole at the state level by imposing the 19.6% fairness fee in New York would go a long way towards meeting several key needs in the state.

The Campaign for Fiscal Equity has been fighting for more than two decades to ensure that every child in New York gets a well-funded education.[24] New York State's Foundation Aide formula is meant to provide sound financing for the State's schools. The Great Recession served to severely hamper the State's ability to meet this commitment and while Foundation Aide increases in the last few years and the end of the Gap Elimination Adjustment have brought school funding up, New York is still well short of meeting its commitment. The Campaign estimates that New York schools are still owed $3.9 billion. The closing of the carried interest loop hole would provide revenues that could be used to try to finally pay off this debt.

New York State recently raised its minimum wage, a long awaited and needed step to ensure that working New Yorkers can earn enough to live in this state. Raising the wage also means that the state must ensure that it reimburses healthcare providers adequately, so that care for our neediest residents is not negatively affected. New York State included some increases to its reimbursements to healthcare providers to in the last budget to defray costs, but more will need to be done to ensure that our healthcare workers are adequately paid while ensuring that no service cuts occur. Other service providers that depend heavily on Medicaid spending also need to see reimbursements increase to ensure that they can adequately pay their staff while continuing to provide necessary services.

These examples above merely refer to those challenges we already know to be facing us. The recent Presidential election brings a whole new, and unknown, set of fiscal challenges. The Affordable Care Act has helped millions of New Yorkers to get coverage[25] through the creation of health care marketplaces and the expansion of Medicaid. The future of the ACA is now in question, as is the ability of New Yorkers to keep their coverage. Any moves to undo federal support for the marketplaces or the Medicaid expansion could force the state to pick up the difference, to prevent a shrinking of coverage. In addition, the new incoming administration's new tax plan proposes to significantly cut taxes, particularly for high income individuals.[26] If this plan is adopted in its current form, the significant cuts to federal revenue will invariably have an effect on State budgets.

<u>Conclusion:</u>

New York should take the lead by passing the proposal championed by Sen. Klein, the Strong Economy for All Coalition and the Patriotic Millionaires to impose a 19.6% fairness fee on carried interest income in order to close the carried interest loop hole. Action in New York, the home of Wall Street, would send a signal to legislators in New Jersey, Connecticut and Massachusetts that this proposal is real and viable. This would bring us closer to addressing a major inequity in our tax system, while increasing revenue by $3.5 billion.

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[24] http://www.aqeny.org/campaigns/campaign-for-fiscal-equity/
[25] http://hcfany.org/category/aca/
[26] http://www.taxpolicycenter.org/publications/analysis-donald-trumps-tax-plan/full

Appendix

Chart of methodology used to determine revenue to State.

	AUM	Expected return	Expected annual return	Incentive fee	Expected aggregate fund manager annual earning	Halved	Tax rate	Expected carried interest loss
HF	$3,088,400,345,317.00	2.93%	$90,490,130,117.79	15%	$13,573,519,517.67	$6,786,759,758.83	19.60%	$1,330,204,912.73
PE	$1,115,392,282,823.00	13.26%	$147,901,016,702.33	15%	$22,185,152,505.35	$11,092,576,252.67	19.60%	$2,174,144,945.52
							TOTAL:	**$3,504,349,858.26**